Lesson 4: Instruments and Strategies of Monetary Policy

Monetary Economics | April 15, 2026

Agenda

- Instruments of Monetary Policy
- Monetary Policy for Recession and Inflation
- Monetary Policy and the Net Exports
- Transmission Mechanism for Monetary Policy
- Monetary Aggregates and Interest Rate Targeting
- Inflation Targeting
- Implications for Monetary Policy

Instruments of Monetary Policy

1. Open Market Operations (OMO) – refers to the buying and selling of government securities.

- Repurchase Agreements (RPs) – transactions wherein the Central Bank buys government securities from banks with a commitment to sell them after a specified period for a certain consideration like interest rate.

  Money Supply: Temporary ↑

- Reverse Repurchase (RRPs) – transactions whereby CB borrows funds from banks using its holdings or inventory of government securities in its portfolio as collateral with an agreement to repay the loan (and hence buy back the securities) at a specified rate and period of time.

  Money Supply: Temporary ↓

A repurchase transaction expands the level of money supply as it increases the bank's level of reserves while reverse repo contracts the supply of money.

- Outright purchases and sales of securities – involves the direct purchase/sale of government security by the BSP from/to the market for the purpose of increasing/decreasing money supply on a more permanent basis. In such a transaction, there is no commitment for both parties to reverse the transaction in the future, creating a more permanent effect on the banking system's level of money supply.

  Money Supply: Permanent ↑ and/or ↓

2. Rediscounting – a standing credit facility provided by the BSP to help banks meet temporary liquidity needs by refinancing the loans they extend to their clients. The rediscounting facility allows a financial institution to borrow money from the BSP using promissory notes and other loan papers of its borrowers as collateral.

– Discount rate and interest rate are just the same. The loan is discounted upfront, so interest is deducted immediately.
– There are three parties involved.

- **BSP** – provides a rediscounting.
- **Bank (e.g., LandBank)** – borrows from BSP using loan papers as collateral.
- **Client (e.g., Farmer)** – borrows from the bank using collateral (like land title).

The farmer borrows ₱1,000,000 from the LandBank at 10% discount. The bank gives ₱900,000 to Farmer.

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LandBank uses the same loan paper to borrow from BSP at a 5% discount rate. BSP gives ₱950,000 to the LandBank.

The loan is discounted twice: first by the bank, then by the BSP.

↑ Discount Rate = ↓ in Money Supply
↓ Discount Rate = ↑ in Money Supply

3. Reserve Requirement (Required Reserve Ratio) – Employed as a protection to depositors by ensuring liquidity or solvency and to meet the withdrawals of depositors.

Liquidity means that the bank has enough cash available to meet depositors' withdrawal requests. Solvency means that a bank's assets can be converted to cash if needed.

Current Reserve Ratio in the Philippines

- 5.0% Universal/Commercial Banks
- 2.5% Digital Banks
- 0.0% Thrift Banks

↑ RR = ↓ in Money Supply
↓ RR = ↑ in Money Supply

4. Direct Controls – consist of quantitative and qualitative limits on the ability of banks to undertake certain activities. The most common types of direct controls include limitations on aggregate bank lending, selective limitations on certain types of bank lending and interest rate regulations.

Government banks have focused sectors. LandBank focuses on farmers and the agriculture sector while DBP focuses on MSMEs.

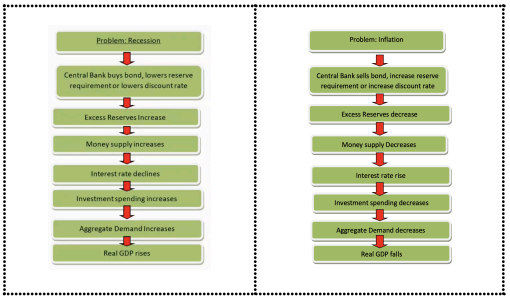
People with connections to the Central Bank could easily access loans before. This is due to the quasi-fiscal function of banks: to help develop the country, banks extend loans more freely. Currently, the BSP is independent, so lending is more regulated and less influenced by personal connections.

Ceiling on Directors, Officers, Stockholders, and their Related Interests (DOSRI) Loans are limits placed on loans to related parties to prevent abuse or excessive risk.

Soft Loans – lower interest rates than regular loans. This is often supported by the World Bank or other international institutions, especially in less developed countries. The lower interest helps encourage development by making credit more accessible.

5. Moral Suasion – defined as the influence that the Central Bank exercises to induce or convince banks to conduct operations in a manner that would contribute to the attainment of monetary goals but may not contradict profit maximization objectives of banks in the short run.

Monetary Policy for Recession and Inflation



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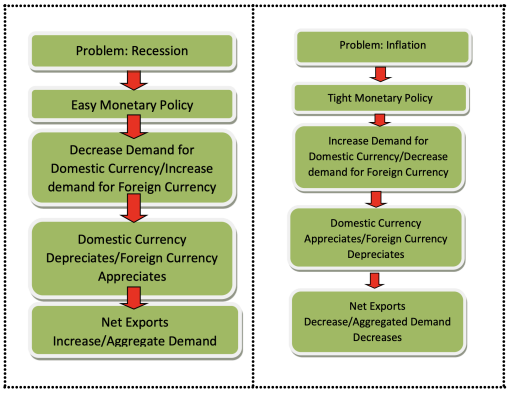
Left Side (Central Bank)

- The Central Bank used monetary targeting which focused on money supply to stabilize the economy.
- Used easy monetary policy to increase money supply since CB used both fiscal and monetary policy.
- During the pandemic, accommodative monetary policy was used to support the economy because economic activity slowed down.

Right Side (Bangko Sentral ng Pilipinas)

- BSP uses inflation targeting which focuses on keeping inflation low and stable.
- Use tight monetary policy to decrease money supply and control inflation.

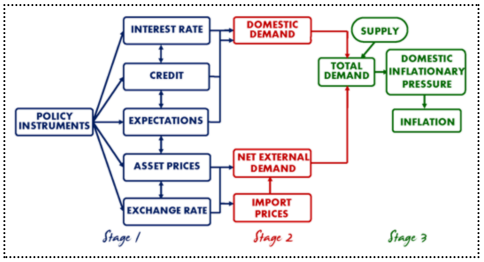
Monetary Policy and the Net Exports


Problem: Recession
Easy Monetary Policy
Decrease Demand for Domestic Currency/Increase demand for Foreign Currency
Domestic Currency Depreciates/Foreign Currency Appreciates
Net Exports Increase/Aggregate Demand
Problem: Inflation
Tight Monetary Policy
Increase Demand for Domestic Currency/Decrease demand for Foreign Currency
Domestic Currency Appreciates/Foreign Currency Depreciates
Net Exports Decrease/Aggregated Demand Decreases

Easy Monetary Policy = ↓ Interest Rate
Tight Monetary Policy = ↑ Interest Rate

Interest rate and domestic demand have an inverse relationship. When interest rates are high, domestic demand decreases. When interest rates are low, domestic demand increases.

Transmission Mechanism of Monetary Policy



The transmission mechanism of monetary policy allows monetary policy to affect real economic activity and inflation through various channels.

Monetary Policy Transmission Mechanism

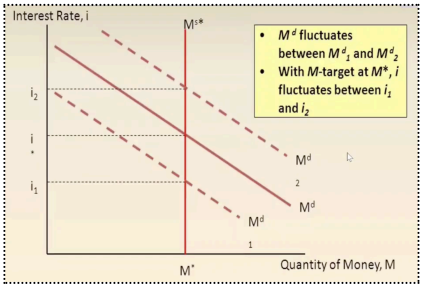
Monetary Targeting

Monetary Targeting – Determine the level of money supply needed to achieve a desired level of inflation.

– Based on the assumption of QTM by Irving Fisher that there is a stable and predictable relationship between money supply and output and inflation (MV = PY)

– The reaction of inflation to changes in money supply is stable.

Monetary targeting and interest rate targeting are incompatible. The BSP cannot perfectly target both money supply and interest rate at the same time.



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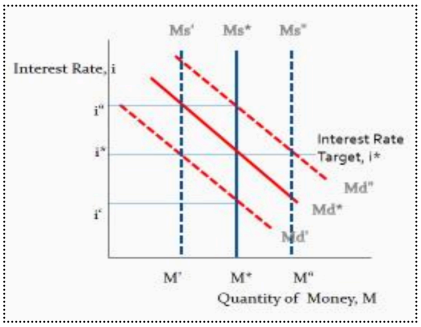
In monetary targeting, the BSP targets the money supply. The vertical curve M^S represents money supply while the downward-sloping lines are money demand curves. Money demand can change because of market conditions.

If the economy improves, money demand shifts from M^D to M^{D2}. Since BSP keeps money supply fixed at M^S, the interest rate increases from i to i^2. If the economy weakens, money demand shifts from M^D to M^{D1}. Since BSP still keeps money supply fixed at M^S, the interest rate decreases from i to i^1.



In interest rate targeting, the BSP targets the interest rate. This time, hindi interest rate ang mag-a-adjust. BSP will adjust the money supply instead.

Money demand can increase or decrease depending on the economy. But under interest rate targeting, BSP wants to keep the interest rate at i^*. If money demand increases, BSP must increase the money supply. If money demand decreases, BSP must decrease the money supply.

The BSP has a certain inflation target, which is 3% ± 1 percentage point. Meaning, the acceptable inflation range is around 2% to 4%.

If inflation is above 4%, it means that inflation is beyond the target range. BSP may use monetary policy instruments.